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# **TRANSITION ECONOMIES AND TRUST BUILDING**

**A network perspective on E.U. enlargement**

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**Theme G: Cross-contextual comparison of institutions and organisations**

# **TRANSITION ECONOMIES AND TRUST BUILDING**

## **A network perspective on E.U. enlargement**

### **Abstract**

Many transition economies are characterised by a relatively rudimentary institutional framework. Weak legislative structures and the absence of effective market regulation and property right enforcement rules often prohibit mutually profitable business transactions and - more generally - restrict the chances for innovation and sustainable growth. Against this background, we analyse the extent to which more efficient governance mechanisms can contribute to a more favourable business environment. In doing so, we adopt a network perspective. We argue that both in developed market economies as well as in centrally planned economies much of economic exchange takes place in networks. However, the characteristics of these networks, in particular the concept of trust, can differ significantly. This implies that the real challenge of the process of economic transition is connected to building new economic exchange networks. In this paper, we discuss this argument and analyse how the current enlargement of the E.U. into Eastern Europe may favourably affect this process of institutional change in the accession countries.

## **1. Introduction**

The institutional framework of a business system has a large impact on the structure and the quality of trans-organisational relationships. In a comparative view, business systems are different due to a variety of cultural and institutional factors. Institutional factors constitutively contribute to the nature of relationships in various ways. For example, trade associations, legal codes and practices etc. are suggested to determine the quality of relationships within and - particularly - between organisations. (e.g. Lane and Bachmann 1996; Sorge 1996; Whitley 1999; Bachmann 2001). With regard to business relationships, differences also translate into the preferred use of underlying forms and combinations of social co-ordination mechanisms like trust and power. Hofstede (1991) and Fukuyama (1995) are prominent approaches to classify the world in areas of varying degrees of trust. In Asia, for example, Fukuyama argues that trust is a particularly important ingredient in business relationships. Also strong forms of trust are observed in continental European business systems such as, for example, in Germany (Lane and Bachmann 1996). At the same time, many scholars who have, for instance, studied the co-ordination of expectations in Japanese supplier relationships (e.g. Sako 1992), found that large Asian buyer firms are not hesitant to use a their power when specifying their demands in terms of delivery times, prices and product quality. Equally, examples of strong power-based relationships are often also identified in Western, particularly Anglo-Saxon, business environments (e.g. Rainnie 1993). It appears that trust and power are elements in all forms of organisational relationships in all parts of the world. The forms and the intensity of behavioural dispositions, however, have strong cultural and institutional roots, which can considerably impact on the performance potential of business organisations.

In transition economies we observe large performance differences as well as large variation in institution building which seems to imply that differences at the national or regional level in

terms of routines, culture and institutions contribute to the explanation of different economic developments in these countries. If this holds true, an adequate theoretical approach to analysing different pathways of transition economies' socio-economic systems is crucial.

In this paper, we explore this line of argument in the analysis of the economic dynamics of the enlargement of the E.U. Following Dyker (2001), we believe that the economic success of this process will be determined by its impact on the growth of the transition economies of the accession countries, rather than by the static once-and-for-all effect on trade. The growth-effect from E.U. enlargement will come from lower risk premiums that boost investments in the newly admitted member states. Depending on the degree of technological congruence and the social capability of the accession countries, the increased investments will enable a more rapid process of technology diffusion that will foster economic growth. The bottom line of our argument is that macro developments such as catching-up , convergence effects, trade integration etc., will take place through a suitable organisation of business transactions. Ultimately, the pattern of transactions, including knowledge and technology transfers, will determine the impact of E.U. enlargement on economic development and growth in the accession countries. Generally, the transfer of knowledge and technology is constitutively embedded in a network context and the fundamental institutional arrangements that surround these. Like any social behaviour, economic exchanges are channelled through specific forms of governance mechanisms. We think that different governance mechanisms such as trust, power and prices allow for as well as support different forms of exchange behaviour. Given the nature of the process of knowledge transfer between old and new EU-member states, the governance mechanism of trust (-building) can be considered a central ingredient in the development of business in the new and larger E.U. Thus in this paper we will address the influence of (trust-based) exchange networks on the potential for success of European enlargement.

In developing the argument above, this paper contributes to the existing literature in the following ways. In the first place, there is relatively little research on the roles of governance elements, such

as ownership structure and transparency on the behaviour of networks . This paper connects to the recent literature that aims to integrate the resource and governance characteristics of networks (e.g. Gulati et. al (2000) and Toms (2002)). In the second place, it adds to the literature on transition economies in providing a framework for the analysis of the interplay of institutional arrangement, trust-building and economic development (e.g. Raiser 2001). And in the third place, it contributes to the literature on the consequences of the E.U. enlargement by conveying the argument that in particular the nature of exchange will be an important determinant of the ultimate (economic) success of this process (e.g. Dyker 2001).

In the remainder of this paper, we will deal with the fundamentals of networks in section 2; and with the role of trust as a governance mechanism in section 3. Subsequently, sections 4, 5 and 6 will deal with the characteristics of economic exchange in the market economy, under central planning, and in transition economies, respectively. This analysis then allows us, in section 7, to describe the characteristics of the process of economic transition and the possible impact of institutional changes on the economic growth and innovation potential. Section 8 concludes our argument presented in this paper.

## **2. A network perspective on the development of business relationships**

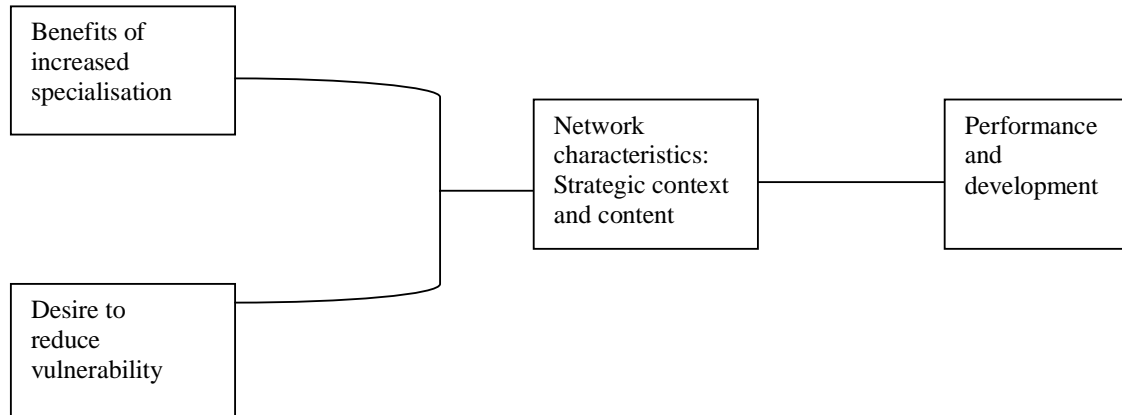
Transaction costs economics is generally based on the notion that agents have the choice to either co-ordinate transactions through prices or direct supervision (hierarchy). This rather dichotomous view on governance, to a large extent, is due to the control perspective of this approach. A more detailed view on the non-price co-ordination of transactions reveals that alternative structures characterised by standardisation (of output, processes, skills and norms etc.) and the mutual adjustment of expectations between trading partners equally serves as governance structure.

Mintzberg's (1979) famous typology of organisational configurations, for example, takes this into account in that it is built upon the diversity of co-ordination mechanisms. The real world is even more complicated and relationships are usually characterised by different combinations of co-ordinating mechanisms.

Against this background, it can be argued that a network can be seen as an organisational form (between or within organisations) in which transactions are not co-ordinated through direct supervision or competition, but through co-operation in the context of relatively informal relationships between trading partners. Thus, network transaction distinguish themselves from market transactions and hierarchical transactions by the nature of the interaction, which is built more on trust than on incentives or command. Co-ordination takes place through commitments, mutual adjustment and the standardisation (socialisation) of norms and beliefs (Miles and Snow 1986; Sydow et al. 1995; Bachmann 2000).

From a resource dependency perspective, it can be argued that firms reduce uncertainty through securing resources by participating in different networks. This view can easily be combined with a strategic content perspective on the behaviour of organisations which considers idiosyncratic managerial and entrepreneurial resources as the drivers of excellent corporate performance, growth and diversification (Barney, 1997, Whittington and Mayer 2000). Thus, the desire to exploit the benefits of increased specialisation from a resource based view perspective is accompanied by the equivalent need to reduce the vulnerability of the organisation from a resource dependency perspective (see figure 1).

**Figure 1: The drivers of network characteristics (strategic context and content)**



Organisational networks are increasingly seen as a promising form of trans-organisational relationships as the clustering of firms enables business partners to share trade secrets and to draw on pools of technology, experience and skilled labour. Networks can provide a solid basis for creating and sustaining competitive advantage. But, like competition, co-operation also has its pitfalls. The interplay of the drivers of network characteristics may also inhibit the growth of firms, industries and regions. In that case the legitimate need to reduce uncertainty may lead to the formation of regional cliques aimed at the preservation of the status quo. The negative effects of entrenchment among members of the network manifest themselves in anti-entrepreneurial and inward-looking behaviour that exhibits a negative impact on competition and economic development. The specific content and context characteristics and dynamics of networks can thus be regarded as driving or, indeed, blocking of economic growth and development. It is this perspective that we propose in this paper to address the impact of the enlargement of the E.U. on the transition economies of the accession countries.

In order to address this issue we have to elaborate upon the functioning of networks in a more detailed manner. In an instructive recent paper, Toms (2002) develops a conceptual model along the lines of figure 1 to analyse network characteristics and dynamics. First, the managerial and entrepreneurial resources fuel networks' capabilities and potentials. These strategic content



factors characterise the organisational formation of the network. To put it differently, networks with control over an extensive resource base have the potential to exploit these resources in a large variety of different business opportunities. Likewise, organisations with control over an extensive resource base have the ability to govern value-creating processes using hierarchical structures. In contrast, organisations that control a narrow resource base are simply forced to enter the market to obtain more resources. In the first context of an extensive resource base, networks substitute for control through direct supervision. In the second context, networks substitute for market transaction and aim at , for example, price agreements.

Second, Toms (2002) argues that the dimension of strategic context, in particular refers to the accountability to stakeholders. Governance structures, such as network agreements can be transparent or opaque. In transparent networks, businessmen are accountable to owners and other stakeholders through the ownership structure, board roles and other structural characteristics. Transactions in transparent networks more easily are value-generating as they are driven by co-operation. In opaque networks there are more opportunities for entrenchment and opportunistic behaviour. As a result, transactions in the context of opaque networks are characterised by hold-up and lock-in problems. Against this background one can argue that, on the one hand, the need to obtain resources in the market (including financial resources) will drive networks that are based upon a relatively narrow resource base towards more transparency. On the other hand, networks based upon an extensive resource base may have a tendency towards opaque inward-oriented governance structures. Taken together, this yields the following taxonomy of network characteristics (cf. Toms 2002: 9).

**Table 1: Taxonomy of Network Characteristics**

		Strategic context as measured by the governance structure, i.e. the accountability to stakeholders	
		Transparent	Opaque
Strategic Content as measured by Organisational Diversity, i.e. the Organisational Resource Base	Extensive	Hierarchy substituting, accountable to environment, high external resource dependence	Hierarchy substituting, self-sufficiency, low external resource dependence
	Narrow	Market substitution accountable to environment, high external resource dependence	Market substitution self-sufficiency, low external resource dependence

Like other institutions, networks change their structure and dynamics according to changes in the business environment and economic opportunities. The organisations' ability to internalise resources is improved by an ex ante extensive resource base. By itself this may pull networks towards hierarchical governance structures and increased opaqueness in order to successfully protect the network from changes in the economic and institutional environment. At the other extreme, a narrow resource base (low organisational diversity or a narrow strategic content) pulls towards market exchanges and more transparent governance structures. In this respect, the wish to survive in a changing environment can only be realised by "going with the flow", i.e. subjecting the network to the accountability requirements of the market. To put it differently, self-sufficiency will stimulate opaqueness and high external resource dependency will provoke transparency.

As far as the underlying governance mechanism is concerned, it can be concluded that opaque networks build on familiarity among its members and the fact that transactions are frequently repeated within the networks. Familiarity breeds trust. Members of transparent networks on the other hand, are more often engaged in anonymous market exchanges. In the latter case, self-sufficiency and resource dependency reflect formal institution building and ideology (competition policy, company law, and rules governing financial institutions) which, of course, raises the standards for accountability norms. Trust in transparent networks will generally be more related to this formal institution building.

In the following section of this paper, we will elaborate upon the theoretical preconditions and implications of the concept of organizational trust as the dominant governance mechanism of transactions in the context of networks (section 3). Against this background, we will then examine empirically testable network characteristics - an empirical study is currently prepared by the authors of this paper - of market economies, centrally planned economies and transition economies, respectively (section 4, 5 and 6).

### **3. The role of trust as a governance mechanism in networks**

Trust is important to enhancing the effectiveness of business relationships that depend on close co-operation, adding to operational efficiency by reducing transaction costs. Following Luhmann's (1979) systems theoretical view and Giddens' (1990) structurationist perspective we see trust as a means to reduce social complexity. Trust can be regarded as an effective co-ordination mechanism that provides chances for social interaction between two parties who might otherwise simply find no way to interact at all. Trust bridges over information gaps and thus reduces uncertainty in that a trustor selects one - or a small number of - positive or desirable

possibility/-ies regards the future behaviour of the trustee. Doing so, a trustor - in Luhmann's terminology - makes a risky investment but what he gets in return is a simpler world where decisions can be made and not everything must be considered all the time.

As, particularly, can be studied in small opaque networks, familiarity breeds trust. Face-to-face contacts and longer-term positive experiences with one another usually foster the creation of trust in such groups of individuals because the risk of misplaced trust tends to be lower where more information about the potential trustee is available and untrustworthy behaviour is sanctioned immediately. The Sicilian Mafia is one the examples which is often referred to in this context. In pre-modern times, business communities also tended to be small and predominantly characterised by inter-personal forms of knowledge sharing. Particularly where repeated interaction is characteristic of the business system, social norms such as reciprocity are powerful mechanisms. Trust building, under these conditions, requires considerable time and effort on part and at the expenses of the individual actors, but can then be very intense and effective.

These circumstances may still be found where regional or professional networks play an important role. Moreover, we argue that they are also characteristic for most transition economies (see section 5). Generally, however, as exit options increase with economic development, large and differentiated socio-economic systems unavoidably also have to utilise other, i.e. impersonal, ways of producing trust in business relationships. Especially strongly regulated business systems generate a high level of impersonal trust constitutively based on reliable institutional arrangements (Luhmann 1979; Zucker 1986; Bachmann 2001). The sources of trust, in other words, can change historically and face-to-face contacts in opaque networks are generally not the way to produce trust in modern socio-economic systems.

#### **4. The organisation of exchanges in the market economy**

In economics the standard mode of exchange is the transaction in the market. Market exchanges are deemed to be smooth and efficient, there are a large number of perfectly informed buyers and sellers, and prices move to clear the market. The analysis of exchange focuses on the market structure, the behaviour of market participants and the resulting resource allocation. As commonly known, however, reality is different. Usually, the numbers of sellers and buyers are limited and information is imperfect and asymmetrically distributed. Transaction costs are intrinsic to any exchange and in an attempt to minimise transaction costs, transactions can be governed by almost a continuum of organisational modes, ranging from arms-length relationships, repeated single contracts, strategic alliances, joint ventures etc. to complete integration (e.g. Williamson 1975). In this view, the organisation of business is largely dependent on the vulnerability of the trading partners with respect to one another's activities. In general, the more (relationship-) specific the assets under consideration, the higher the potential benefits and risks for the trading partners and the more tailor-made is the governance mechanism of that particular transaction.

In the analysis of the mechanisms governing transactions, the economic and sociological perspective show a number of interesting differences (see also Nooteboom, 2002). In neo-classical economics as well as in transactions costs economics, a transaction is a static equilibrium situation. The transaction, as the unit of analysis, is considered an isolated event, which is organised as effectively and efficiently as possible. In doing business, the trading partner is to be encountered with suspicion, as he/she is rationally acting upon his self-interest only and the organisation of the transaction is motivated by the desire to optimise control over the situation. By contrast, in the sociological approach, the focus is much more on the contextual conditions and the dynamics of the transaction. The transaction is part and parcel of an evolving network of ongoing relationships between the trading partners. Single transactions are regarded as

an investment in the network of relationships, which may be based on trust and the desire to benefit from one another's knowledge through mutual adjustment. As argued above, economic exchanges in a modern market economy are not only governed by inter-personal relationships but, particularly, by 'extended trust'. On the basis of an analysis of the World Value Survey Data, Raiser et al. (2001) conclude that the level of semi-personal and impersonal - i.e. 'extended' - trust, is positively correlated with economic growth. In developed market economies, transaction networks are to be seen as the rule rather than the exception (Baker 1990). The ongoing globalisation of the economy and the increased competitive pressure from the global market, pushes firms to concentrate on the activities that produce the highest quasi-rents (core-competencies). Non-core activities are outsourced. The concentration on core-competencies implies concentrating on advanced general-purpose technologies, rather than product specialisation, which enable a multitude of alternative strategies in very different directions. At the same time, the increased flexibility in the application of production technology comes along with co-operation (rather than competition) in the development and introduction of new products or processes (Milgrom and Roberts, 1990). Thus, the capability to share (tacit) knowledge with a large variety of alternative firms emerges as a key to sustainable competitive advantage (Barney, 1997). Business transactions in modern market economies take place in the context of extensive networks, characterised by strong mutual reliance on trading partners and mostly motivated by the desire to co-operate rather than to compete.

Conventional economics with its traditional focus on competitive transactions (in markets) has relatively little to say about the efficiency and effectiveness of co-operative transactions in networks. Also transaction cost economics emphasises control and competition, which is of limited use in the explanation of the dynamics of organizational co-operation. In many ways, the aforementioned socio-economic and neo-institutionalist approaches which emphasise trust, institution- and relationship-building appears to be more fruitful as the starting point for the analysis of exchange in business networks in developed market economies (Nooteboom, 2002).

## **5. The organisation of economic exchanges under central planning**

Also with respect to the organisation of transactions in the centrally planned economy, economic theory has not much to offer. In many ways, the central planner is formally equivalent to Walrasian auctioneer. It seems paradoxical that the alleged superiority of a market economy is grounded upon an analytical framework in which central planning and market exchanges follow the same logic. By analogy to the decentralised exchange in the market economy, central planning builds on centralised contracting. In accord with transaction cost economics one can conclude that the centrally planned organisation of exchange probably saves on co-ordination costs but, at the same time, increases enormously agency and influence costs. Moreover, central planning is detrimental to the incentive structure fostering state-bribery and corruption. Under communist regime, all this resulted in a situation where the actual allocation of resources deviated fundamentally from the planned allocation. Many exchanges actually took place in the context of local networks as prohibitive transaction costs stimulated informal exchange networks on the basis of repeated interaction and familiarity. Thus, a centrally planned economy cannot be denoted as a strongly regulated economy building on institutional-based, i.e. 'extended', trust. It is largely process-based or characteristic-based trust (Zucker 1986) that governs a large part of economic exchanges in the local networks. Distrust restricted the scope for social interaction and social capital was previously a scarce resource in those Eastern European economies which are now about to join the E.U.

In this respect, Rose's (1995) metaphor of the 'hour glass society' hits the point (Raiser et. al. (2001). Under communism, individuals organised their transactions along strong mutual ties at the level of family- and friendship-based relationships in order to survive in a hostile environment. This network organisation not only structured transactions 'at the bottom' but also

‘at the top’ of society, where opaque circles of the privileged and powerful made exchanges to maintain the social status quo. All these networks were inward-looking with little or no interaction between different networks. The entrenchment among network members seriously affected regional economic development in communist countries (and many other less-developed countries).

To conclude, like the market economy, actual exchange under central planning also took place in the context of (local) networks. However, unlike the market economy the exchange networks in the central planned economy occurred as an officially not legitimated structure and were aimed at survival and maintaining the status quo rather than enabling best practice and sustainable competitive advantage.

## **6. The role of trust and control in transition economies**

The transition from central planning to market economy can be viewed as a process of accelerated change. Economic transition does not only require changing relative prices but the entire set of economic, legal and social incentive structures governing economic behaviour. Transition economies are thus generally characterised by a weak institutional structure. In the process of change, the system of commercial law is not functioning effectively, the enforceability of contracts is limited and competition is inadequately regulated. At the same time, entrepreneurs in these countries cannot hope that these conditions will develop very quickly. The reforms of institutions in transition economies unavoidably creates considerable uncertainty and many forms of opportunistic behaviour (van Ees and Garretsen 1994).

Transactions in transition economies take place in the context of the following exchange networks. First, exchange networks that are built on personal relations among members of new Mafia like clans. Second, the opaque networks of the old communist nomenclatura that have



survived the transition. These networks are characterised by personal obligations and serious problems of accountability. To some extent, these two forms of social networks represent the sunk investments in relationship capital of individual network members. Economic exchange is facilitated to the extent that informal social capital compensates for weak formal social capital. Third, the economic transition has also stimulated the advent of new market-based networks. These new networks are transparent and based on the allocation of property rights with formal contracts. Generally, the relationships between network members are relatively informal, open to innovation and the exploitation of new business opportunities. At the same time, the relatively narrow resource base makes these market-oriented networks vulnerable to any form of monopoly power, and investing trust in potential business partners becomes a highly risky business under these circumstances.

We suggest that only developed market economies constitutively build upon ‘extended trust’. To a large extent, transactions are anonymous and trust in the law as well as in other institutions is vital to the existence of market exchanges. In contrast, transactions in the centrally planned economy are governed by a system of official hierarchy and an unofficial personalised system of network exchanges. In transition economies, the hierarchy of the centrally planned economy has more or less collapsed, but given path-dependency, the underlying governance mechanisms are to a large extent still in place. Moreover, in the absence of strong new institutions, within the contexts of opaque networks personal trust remains one of the few governance mechanisms that is able to reduce uncertainty. Raiser et al. (2001) report on the basis of survey data that the level of ‘extended trust’ is notoriously low in transition economies. Thus, personal trust as a mode of coordinating behaviour in a relatively hostile environment, is one of the few means to facilitate cooperation. Under these conditions, the level of trust based on stable institutions as well as open and efficient networks structures is low. Raiser et al. (2001) report that participation in organisations such as labour unions or trade associations is generally low in transition economies

while trust in institutions is not generally lower than in developed countries. But, notably, among the exceptions are the law and commercial associations.

## **7. Ex-/Importing transparent networks to/in the transition economies**

We suggest that the economic transition of Eastern Europe can be conceptualised as the process of replacing the old opaque networks by newly established transparent networks that connect businesses to a market-oriented environment. Together with the creation of new networks, the parallel development of ‘extended trust’ has to be stimulated through property rights enforcement, competition policy and trade regulation in order to cut off the roots of the old opaque networks of central planning. In this respect, third-party enforcement by a credible state (or the E.U. for that matter) is an important issue. That is to say that serious credibility and incentive problems arise to the extent that the state is still associated with the old opaque networks and government officials engage in rent-seeking activities such as supporting loss-making industrial dinosaurs, non-monetary transactions (bribes) and high taxes for new-comers. Our analysis of the dynamic forces governing transactions in networks illustrates that opaque and self-sufficient networks tend to become more opaque in response to external threats, which may seriously hamper economic transition. Low trust in existing institutions decreases the chance to develop ‘extended trust’ necessary for the transition to a full-fledged market economy. Thus, on the one hand, the disintegration of the (old) state is necessary for the emergence of ‘extended trust’ but, on the other hand, also makes it less likely that sufficient ‘extended trust’ will develop. The real challenge of economic transition is to create legitimacy for new institutional structures which foster existing and newly created transparent networks that are favourable to strategic restructuring (even in periods of economic decline).

If trust-based transparent networks of firms which together have a sufficient resource base are an economically promising way of balancing principles of market and hierarchy, the key question seems to be: How can this organizational approach be encouraged specifically under conditions prevailing in the transition economies of the E.U. accession countries? The enlargement of the E.U. may offer unique chances. But - depending on the strategy and speed of integration - different effects on the socio-economic systems of the candidate states are to be considered. In the context of our network perspective on the development of business relationships (section 2) we foresee at least three possible scenarios for socio-economic development.

*Scenario 1:* The remains of the institutional regulation of the communist regime are destroyed and the opaque networks of the former unofficial economy are invalidated. This is the approach that has brought Eastern Germany into the Western economic world. In the end, the opaque networks did not survive the transition to the market economy. At the same time, the West-German industry never bothered to create new more transparent networks together with East-German firms but, instead, built up their own subsidiaries in the East. The result was high unemployment and a social climate of distrust as the superior performance of the West-German economy provided a solid basis for their rent-seeking activities. Social costs were high and the outcome seems sub-optimal, both in economic and in social terms. This may be called the *take-over scenario*. This scenario creates highly fragile networks in the transition economies with characteristics described in the Southeast Quadrant of Table 1 of network characteristics. In practice, it is unlikely to occur with the enlargement of E.U., at least in the stronger transitions economies since these have all already taken serious steps to adapt their socio-economic systems to the Western European model.

*Scenario 2:* The patterns of the transition economies' old business systems are preserved as far as possible. This scenario is favourable to the existing networks in the transition economies. Opaque networks are encouraged to harvest the benefits of E.U. financial support and to free ride upon the reputation of the trade E.U. institutions. Influential opaque networks will find little reason to give

way to a more value-oriented economic development. In this scenario it can be expected that some opaque networks will take a long-term perspective and survive when the transition will be completed after an extended time period. Many of these networks, however, will try to exploit the situation until this is no longer possible. This scenario may be called the *Mafia scenario*. Trust is a matter of personal relationships within the closed circles of obligation based business clans while 'extended trust' has few chances to grow in this environment. The Mafia scenario creates highly opaque low-performance networks in the transition economies with characteristics described in the Northeast Quadrant of Table 1 of network characteristics.

*Scenarios 3a and 3b:* The import of value-oriented ideas is channelled through intermediary institutional structures such as trade associations, chambers of commerce, technology transfer institutions etc. Here, the role of the transition states' governments is to provide support for economic co-operation in the form of strategic partnerships among Eastern and between Eastern and Western firms. The enlargement of the E.U. would then basically be carried out by Western and Eastern (European) business networks which search for suitable partners in the other part of the European hemisphere. In this scenario, which may be called the *value-oriented innovation scenario*, it is supposed that transparent networks are encouraged to build their relationships on trust even when the resource base of many single firms participating in these networks is narrow. Innovation will be the central focus of these networks. This scenario has two sub-types. Depending on whether it is driven by firms of the old EU members (located in the Northwest quadrant of table 1) or by the firms of new EU members (located in the Southwest quadrant of table 1), failures of these options are either pulling towards scenario 1 or scenario 2.

**Table 2: Network development Scenarios in a taxonomy of Network Characteristics**

		Strategic context as measured by the governance structure, i.e. the accountability to stakeholders	
		Transparent	Opaque
Strategic Content as measured by Organisational Diversity, i.e. the Organisational Resource Base	Extensive	Value-oriented (driven by the old EU member states)	Mafia clan Scenario
	Narrow	Value-oriented (driven by the new EU member states)	Takeover scenario

The manifestation of a particular scenario predominantly depends on the strategic content and context of the networks including the sources of the trust that play a role within and around these networks. Transparent networks drawing on an extensive resource base may offer the best chances for transition economies and hence for European integration. Existing opaque networks are to be developed towards more transparency. In many cases, however, transparent networks will have to be developed from scratch, either by way of substituting hierarchy or pure market-based relationships. This observation is in line with the fact that firms in transition economies particularly need managerial support to meet the requirements of the challenges of the market economy (Gergs 2002). In the situation, a narrow resource base re-enforces the need for market orientation, which presumably offers the greatest potential for economic growth. This is the more so as alternative control structures, in particular ownership, are not yet a focal point in the mind map of the Eastern European managers (Steensma and Lyles, 2000). However, this scenario also contains high risks when the institutional safeguards are not fully developed (yet). ‘Extended trust’ will have to build on open communication and originate in networks relationships while simultaneously drawing on institutional arrangements in the business environment. Thus, a favourable way of developing innovative networks supports a hybrid form of trust creation.

Neither institutions nor inter-personal contacts as such are sufficient to produce an optimal combination of ‘bottom up’ and ‘top down’ mechanisms of co-ordinating expectations and interaction between business partners (Bachmann and van Witteloostuijn 2002). From our point of view, an optimal form of networks presupposes powerful rules rather than powerful actors and a form of trust that allows for long-term orientations and flexibility at the level of inter-personal relationships.

## **8. Conclusion**

Building upon the argument presented in this paper, we believe that the economic success of the enlargement of the E.U. will depend upon the extent to and the way in which firms in the transition economies will be able to enter what we call ‘value-oriented innovation networks’. As compared to the take-over scenario, on the one hand, and the Mafia scenario, on the other, the ideal pathway is constitutively based on a gradual learning process where either Eastern or Western firms can take the lead when new East-West networks are to be build. Although transparent networks with an extensive resource base may have the highest growth potential and are to be preferred ultimately, it seems that the creation of transparent networks with a relative narrow resource base are a viable and fruitful next step in the trajectory of the accession countries. Networks with a relatively narrow resource base are more oriented towards the market, whereas networks with a relative extensive resource base have a tendency to become more opaque and inward looking in response to external threats. As the vulnerability of networks with a relatively narrow resource base is considerable, particularly in environments where the institutional safeguards are not fully developed, the key to success for a value-oriented scenario is however, the parallel development of a reliable macro-institutional framework.

Foreign direct investments in, for instance, Estonia, Hungary, Poland and the Czech Republic are already at a high level and will probably not change dramatically as a result of the E.U. enlargement. Increased European integration will be beneficial to transition economies, if as we have argued the E.U. enlargement strengthens the creation of transparent trust-based business networks in the accession countries. Clearly the E.U. membership can help to establish a sound property-right structure and to codify competition and trade policy. All this may increase investor confidence allowing for rapid diffusion of technology, knowledge and economic growth. However, for that to happen, a far-reaching integration of the accession countries' economic activities into the networks of the old E.U. business world are a *conditio sine qua non*.

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